CREDIT STANDARDS IN AN INFLATIONARY ECONOMY

An Address by Oliver S. Powell, Member,
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It is a genuine pleasure to appear before the National Conference of Commercial Receivable Companies to discuss the broad questions of inflation and its restraint through credit standards. As the name of your organization implies, the companies composing this group are primarily interested in supplying working capital by loans on business receivables. At the same time, I am sure that in these days of a growing defense effort which has caused a considerable shift in manufacturing activities among companies and a great growth in sub-contracting, your field of lending must now be considerably broader than in normal times. I am sure that you are providing working capital through the financing of inventories and work in process and possibly in many other ways. May I also assume that you have an unusually close relationship with the companies for which you provide funds to the extent that they depend heavily on your advice and counsel? If so, the member institutions of this conference can perform an invaluable service not only through channeling loans into essential industries but also through their advice and the explanation of the inflationary aspects of expanding non-essential operations.

The title of this talk might have been labeled, "Learning to Live with National Defense". Outside of actual war-time conditions, the United States for generations has found it possible almost to forget defense against outside enemies and to devote its energies completely to developing a higher standard of living at home. Now we find ourselves the most powerful non-communist country in the World, able to depend on other countries for protection only in
very limited ways and faced with the problem of rebuilding a strong national defense.

The problem resolves itself into one of increasing the production of defense items while maintaining the supply of civilian goods at as high a level as possible. If the total demand for goods exceeds the supply, prices go up. This is inflation. It hurts the civilian economy and increases the cost of the defense program.

Early in 1950 the recovery of business from the minor recession of 1949 had brought the level of production, consumption and employment to a high plateau. Production was almost at capacity, a point beyond which it is difficult to expand except by the slow processes of population growth, more factories and improved industrial techniques. Then came the Korean invasion and it set off a rush of panic buying. Remembering the shortages that developed during World War II, we rushed to the stores and bought abnormal quantities of merchandise—everything from sheets and coffee to television sets and autos. There were two waves of buying—autumn and winter. There was also an unprecedented increase in residential building. This buying rush caused retailers and manufacturers to step up their purchases and production rates, and there was a sharp increase in employment. The inevitable result of all this was a sharp rise in prices, and another round of wage increases.

It is important to analyze the sources of buying power which made possible this abnormal buying movement which was superimposed on a high level of peacetime trade. There were three principal sources of buying power:

First, current income: The sum total of wages, rents and income from invested capital which normally just about equals the production of goods and services at stable price levels.
Second, the use of savings by drawing down savings accounts, cashing savings bonds and spending funds which had remained idle in checking accounts awaiting a suitable time for use.

Third, borrowing against future income: Consumers' borrowings to buy automobiles, household appliances and houses; business firms' borrowings to increase inventories or to pay higher prices for inventories or to extend credit to consumers, or to expand plants.

The combination of these three sources of buying power, when used to purchase a quantity of goods and services that could not expand with equal rapidity, caused a sharp price rise.

The monetary authorities have made important moves in their field of action to counteract these inflationary forces.

(1) In August 1950, the discount rates of the Federal Reserve Banks were raised somewhat and short-term money rates were allowed to rise.

(2) The consumer credit regulation was reestablished. The reestablishment of this regulation has not brought about any drastic reduction in the total of consumer credit outstanding. Although the total has declined by 120 million since last December, the amount of consumer credit outstanding on August 31, 1951, was still $19 billion. It rose $171 million in August (annual rate of $2 billion) after Congress eased the restraints.

(3) A new regulation dealing with real estate credit was imposed. It is still impossible to appraise the restraining effect of Regulation X since builders are working on the backlog of orders received before Regulation X was announced, and on public housing projects as well as on private construction under the regulation. Moreover, Congress liberalized the terms in August.
In January 1951, reserve requirements of member banks were raised to substantially their upper legal limits.

One of the most important tools of inflation restraint was practically out of use for this purpose for several years. This was the employment of open market operations, which were devoted almost solely for several years to maintaining a pegged price for long-term Government securities. The Federal Reserve Open Market Committee first announced in the depression years that a major objective would be a stable or orderly bond market. This was at a time when the Federal Government was borrowing heavily to provide funds for various kinds of relief. Then came World War II with its huge expansion of public debt. The Federal Reserve played an important part in this financing by providing the banks with excess reserves with which to buy Government bonds.

Then came the post-war years. Almost everyone expected a sharp depression as had happened in 1920-21 after World War I. Hindsight proves this to have been an error in judgment but it was a factor in causing the Federal Reserve authorities to continue their easy money, excess reserves, pegged bond market policies. With one or two minor exceptions this policy was maintained until last Spring when the pressure of inflation made a change to a more flexible attitude toward the bond market necessary.

The pegging of the Government bond market had deep-seated effects. Holders of long-term bonds instead of treating those securities as true investments came to consider them equal to cash in liquidity. In fact they were the equivalent of cash so long as they could be sold to the market at a fixed rate and the market could be sure that it could sell them to the Federal Reserve Banks at the same price. This caused the Federal Reserve Banks to manufacture...
bank reserves at the whim of the holders of Government securities.

The reduction in prices of long-term Government bonds last Spring has had far-reaching effects in the control of inflation. Holders of those securities have been reluctant to dump them on the market and as a result supplies of funds from that source for mortgage loans and for many other types of credit have been reduced. Skeptics of this change in the administration of the Federal Open Market Account have overlooked two aspects of the money market: First, low rates had been in force for so many years that they had been built into the financial structure. Any change to a higher level of long-term money rates forces far-reaching adjustment in financial commitments. Second, the direction of movement in the money market is an important factor entirely aside from the level of money rates. Whenever rates are rising, until the money market reaches reasonably firm ground at a higher level, it is natural that many financing plans are postponed. One of the most fundamental results of this recent action has been to restore in the rest of the world a confidence that we can control our own inflationary problems.

The credit policies of the Federal Reserve System have been reinforced by a Program of Voluntary Credit Restraint among private lenders. Each supplements and increases the effectiveness of the other. The general credit policy of the System is intended to reduce the availability of credit in the aggregate and to make it unnecessary for the System to add to the credit base by the continued purchase of Government securities; the selective credit controls are designed to restrain the extension of credit in a few areas where the formulation of specific and generally applicable lending standards is feasible. Reliance
has been placed upon the voluntary credit restraint effort to engender a
spirit of caution and restraint in lending policies in general, but especially
in sectors not amenable to selective credit controls, and to assist in channel-
ing the reduced supply of credit so as to meet the needs of the defense program
and of essential civilian activities, while at the same time restraining or
curbing the use of credit for nonessential purposes.

The Voluntary Credit Restraint Program is in essence nothing but
enlistment of the collective horse sense of all kinds of lenders to sort out
the kinds of credit which should have priority under today's conditions and in
that way to avoid Governmental regimentation of credit which, at best, must be
a clumsy affair.

This Program was inaugurated under the provisions of Section 708 of
the Defense Production Act. The authority to set up the Program was delegated
to the Federal Reserve Board. That body requested a group of financial leaders
to draw up a statement of principles and procedures for the voluntary program.
The Federal Reserve Board then consulted with the Federal Trade Commission and
obtained the approval of the Attorney General of the United States for the
Program on March 9, 1951.

We have now come to the principal part of my talk--the credit
standards appropriate for an inflationary period. The first statement of such
standards appeared in the Statement of Principles to which I have referred.
Credit men were asked to screen their loans not only as to credit worthiness but
as to consistency with our national efforts to contain the inflationary pressures.

Listen to these sentences from the Statement of Principles:

"It shall be the purpose of financing institutions to extend credit in such a way as to help maintain and increase the strength of the domestic economy through the restraint of inflationary tendencies and at the same time to help finance the defense program and the essential needs of agriculture, industry and commerce.... It is most important that loans for nonessential purposes be curtailed.... The criterion for sound lending in a period of inflationary danger boils down to the following: Does it commensurately increase or maintain production, processing and distribution of essential goods and services?"

The Voluntary Program did not attempt to supersede the work of Federal agencies in the field of inflation control. It does not have to do with such factors as inflationary lending by Federal agencies which the Statement of Principles states "should be vigorously dealt with at the proper places". Neither does the Program "seek to restrict loans guaranteed or insured, or authorized as to purpose by a Government agency, on the theory that they should be restricted in accordance with national policy, at the source of guaranty or authorization".

The first step in putting the Program into action was for the Federal Reserve Board to request all lenders in the United States to take part in the Voluntary Program. For this purpose a letter was sent to some 90,000 lenders, the broadest list available to the Federal Reserve Banks. Thus the members of this association are in the program to the fullest extent dictated by your good judgment.

The next step was the appointment of a national Committee by the Federal Reserve Board. This Committee is composed of men chosen from the
Principal kinds of lending institutions, with a Federal Reserve Board Member as Chairman.

The national Committee has set up regional committees to deal with problems in five major lending fields: commercial banking, life insurance, investment banking, savings banking, and the savings and loan system.

You will note that there are no regional committees representing finance companies. This is in accordance with the wishes of the various types of finance companies operating in the United States. Last summer a group of finance company leaders was invited to Washington for consultation with the National Voluntary Credit Restraint Committee. We explored the trends in finance company operations and their relationships with the institutions from which finance companies borrow. The consensus of the meeting was that it was not necessary at that time to add to the organization of the Voluntary Program by setting up regional committees to which the finance companies could submit problem cases. The finance company representatives stated that they would prefer to talk their problems over with banks, insurance companies or others from whom they obtain funds. The National Voluntary Credit Restraint Committee has requested that those institutions making loans to finance companies should screen such loans as to purpose. The lending institution has such an intimate knowledge of the finance company to which it is lending that an adequate opinion can be formed as to the desirability of expansion of the finance company's operations before an additional loan is made. No adverse opinion has been expressed as to any particular method of obtaining such funds, whether by direct loan, by the sale of subordinated debentures or by other means. The sole test at this time is the use to be made of the borrowed funds.
Right from the start the national Committee recognized the need for direct contact with lenders to explain the Program, to answer the most pressing questions without delay, and to insure uniform interpretation throughout the nation. The national Committee has issued a series of bulletins to all lenders on credit problems in relation to the Voluntary Credit Restraint Program. The first bulletin dealt with the subject of inventory loans. In view of the rapid increase in inventories, particularly at the retail and wholesale level, the Committee decided that this was its number one problem.

To assist lenders in determining the amount which they might appropriately lend for inventory purposes, the national Committee requested financing institutions to:

1. Refrain from financing inventory increases above normal levels relative to sales, or reasonable requirements by other conservative yardsticks.

2. Encourage borrowers who already have excess inventories to bring these commitments and inventory positions in line as promptly as is reasonably practical.

Bulletin No. 2 dealt with credit for plant expansion. According to Government estimates, business firms were planning to spend about $24 billion on plant expansion in 1951. While part of this money would come out of corporate savings, a large part would need to be financed by borrowing. Furthermore, regardless of the sources of funds, it seemed very doubtful to the Voluntary Credit Restraint Committee that expenditures of this magnitude, aside from those directly related to defense, could be carried through without exerting undesirable inflationary pressures. To guide lenders in channeling credit or capital into the most desirable work under today's conditions, lending
Institutions were requested to refrain from furnishing funds for:

1. Construction of facilities to improve the competitive position of an individual producer of nonessential goods.

2. Expansion and modernization expenditures of concerns in distribution or service lines where the distribution or service is not defense supporting.

3. Expansion and modernization programs for the manufacture of consumer goods not related to the defense effort.

Summarizing the statement of principles and the bulletins, it can be said that the recommendations are of two sorts: first, as to desirable and undesirable purposes for credit and second, as to maximum limits for certain kinds of credit. The Program was inaugurated on the theory that the purpose should determine whether or not a loan should be made. However, very early in the operation of the Program it became evident that it must be dovetailed with the Regulations of the Federal Reserve Board in some fields of credit; therefore maximum credit limits were recommended in the fields of real estate and securities loans. In the latter cases, the objective was still to reduce the amount of credit to a point where speculative price increases would be discouraged.

In interpreting these trends in the credit field, it is important to keep in mind that the purpose of credit policy in general, and of the Voluntary Credit Restraint Program in particular, has not been to prevent the use of private credit. The objectives of credit measures are rather to attempt to stop the use of credit for speculative purposes, to channel credit into
defense and defense-supporting activities, to reduce the credit made available for postponable and less essential civilian purposes, and to engender a more cautious and careful lending policy on the part of lending officers.

The Voluntary Credit Restraint Program has provided the financial section of our economy with a vital rallying point. Even though the inflationary possibilities of credit expansion were fully understood, there still was needed some mechanism for joint action. No lending institution likes to be known up and down main street as being out of step with its competitors.

Perhaps the most significant and abiding contribution of the Voluntary Credit Restraint Program is that it has given lending officers new benchmarks for use in their appraisal of loan applications. It has broadened their horizon beyond the fairly limited objective of appraising the credit-worthiness of a prospective borrower. The Program has made them increasingly aware of the importance of credit policy in an economic stabilization program, and it has contributed to prudence in lending. Equally important, these have been achieved without shutting off the supply of credit to borrowers with needs in accord with today's part-defense, part-peacetime economy, and without imposing upon lending operations a burdensome harness of detailed and specific rules and regulations. This has helped keep to a minimum the injustices and inequities which are inescapable under a set of detailed rules and regulations, no matter how carefully drawn, and has preserved the flexibility of movement required by financial institutions if they are to serve the needs of the economy.

Returning now to the over-all national picture, the threat of inflation has not been removed, although it is not possible to predict when the next upsurge in inflationary pressures will occur or what proportions it may assume.
The lending activities of this Conference are vitally affected by trends in inventories. During the past year business inventories have grown by an estimated £17 billion. This was partly due to higher prices. Earlier it was due in large part to an effort by retailers and manufacturers to keep ahead of an expected increase in trade and of shortages of manufactured goods. Then came the period of realization that retail sales were not going to expand indefinitely and merchants have been cutting down their inventories for several months. Manufacturing inventories, however, have continued to rise, a fact which I attribute largely to the growing volume of defense work in process. The defense manufacturing pipeline has been filling up. This increase in inventories will stop when deliveries of finished goods become equal to purchases of raw materials and investment of labor in the unfinished product. In this connection, it is significant that in the third quarter of 1951 deliveries of military goods were more than four times the delivery rate a year ago.

There is an interesting relationship between changes in business inventories and inflationary pressures. During the past year of increases in inventories, the result was to create more than a normal demand for raw materials, for the inventory purchases were added to consumer purchases in that period. When inventories stop rising the effect will be to reduce the spending stream. In other words that development would wipe out one of the most important inflationary factors which has been in the picture since the Korean incident in June 1950.
Business inventories are at peak levels and the pressure to reduce them still continues. The productive capacity of the country is tremendous and the record levels of plant and equipment spending are augmenting that capacity month by month bringing us closer to an ability to satisfy all demands. Nevertheless, it is not clear that production can be increased sufficiently fast to cover the increased takings for military equipment that are in prospect, without some reduction in supplies available for the civilian market. It is significant that steel output is already 2 per cent above rated capacity and unemployment is the lowest since World War II. Defense spending is rising rapidly and a growing percentage of our defense outlays is going into "hard" goods for which basic materials are short. This rise in defense spending, with unemployment at very low levels, poses the prospect of continuing upward pressures on wage rates and increases in personal income. Business spending for plant and equipment, at record levels, may remain high for some time to come.

The consumer remains a big unknown in the outlook. Following the two "scarce" buying waves of mid-1950 and early 1951, consumers reduced their spending and increased their savings substantially in the second and third quarters of this year. Currently, consumers are spending a significantly smaller portion of their income than was customary in the postwar years. But it is not certain how long it will be before money will again start to burn holes in the pockets of consumers. The new tax law will be a restraining influence but only to a limited extent. The large inventories of goods in consumers' hands, resulting from the overbuying during the past year, will
gradually disappear. With personal income at record levels, and likely to increase further, and with large holdings of liquid assets widely distributed, the basic ingredients for an upturn in consumer spending are present in the economy. Even without adverse developments on the international front, consumer spending is likely to increase; given deterioration in the foreign situation, the rise in consumer spending might assume large proportions.

May I close with a word to you as representatives of private finance? There are those who say "Why should we restrain credit and turn down profitable business when there is a strong possibility that some Government credit agency will step in and make the same loan?" Others say, "Why restrain credit at all, when extravagance is still evident in many places?" The answer to such thoughts should be obvious. The failures of others to do their utmost in the restraint of inflation does not relieve us of the obligation to do our best. If we do our part, we shall have the satisfaction of a job well done. In years to come the finger cannot be pointed at private finance for having failed in its part of the fight against inflation and we shall have set an example to be emulated by all others charged with parts of this important campaign.